01990307.SLF

DEPARTMENT OF STATE REVENUE

SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 99-0307SLF
Individual Income Tax
Calendar Years 1995, 1996, and 1997

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ISSUE(S)

I. **S Corporation** – Pass through to Shareholder

Authority: 45 IAC 3.1-1-66

Taxpayer protests the disallowance of commissions paid to drivers.

STATEMENT OF FACTS

Taxpayer was granted a rehearing in which it protests that officer compensation has been added back and that cost of goods sold should be thirty percent (30%). After the initial hearing, the hearing officer returned the file to the auditor for additional information. Taxpayer's S-Corporation was audited for calendar years 1995, 1996, and 1997, the result which flowed through to the 100% shareholder.

Taxpayer used cash to compensate its pizza delivery drivers. No documentation such as pay calculations, receipts, work summaries, names, addresses, social security numbers were provided to support the taxpayer's deductions for driver wages. Since the taxpayer had no substantiation to support this deduction, the auditor felt the deduction should be disallowed. However, the taxpayer argued for some type of equity treatment based on the fact that it could not be in the pizza delivery business without incurring some kind of delivery expense. Therefore, the auditor allowed a deduction based on industry standards, which includes all salaries and wages. The methodology employed by the auditor involved reviewing the 1997 Restaurant Industry Operations Report. Although there were no statistics available for a business that was limited to strictly carryout and delivery, information was available for limited fast food restaurants. Salaries and wages of a limited service fast food restaurant are 28% (actually 27.8%) of sales. The auditor used this percentage and applied it to the sales of the taxpayer to derive a labor percentage. The resulting amount was reduced by officer and management costs. The net amount was assumed to be an accurate representation of the taxpayer's delivery costs. It should be noted that the taxpayer also presented statistical data for related restaurants and the labor percentages in that data were equal to or lower than the percentage used by the auditor.

I. S Corporation Income – Pass through to Shareholder

DISCUSSION

Taxpayer is a shareholder in an S Corporation. Upon audit, an adjustment was made to the corporation's income tax return, which flowed through to its shareholder. The adjustment relates to the disallowance of wages and mileage paid over and above the industry average.

Taxpayer states that the president's wages were included in the twenty-eight percent cost of goods sold that relates only to its drivers and managers. Taxpayer further states the labor percentage should be thirty percent (30%).

The auditor allowed twenty-eight percent labor, as a percentage of sales, that includes all labor including the officer compensation. Because the manager and owner wages were reported on the W-2's, those amounts were deducted from the resulting 28% percent, the balance of which was attributed to the drivers.

Taxpayer states that driver mileage should be $251,347, $336,391, and $388,644 respectively for 1995, 1996, and 1997 which does not include the owner's wages. Because the taxpayer maintained no records for the drivers, the auditor allowed the industry average of 28% for all salaries and wages and deducted the shareholder and manager wages which resulted in a balance for driver wages. The department allowed $88,534.17, $153,021.67, and $193,362.07 respectively for 1995, 1996, and 1997 which is the balance of the industry standard after deducting the manager and owner's wages. The audit adjusted to the industry standard because the taxpayer had no names, receipts, work summaries, 1099's, or other required documentation to verify that the expenses were valid.

The adjustments to the S-Corporation resulted from disallowed deductions due to use of cash with no reliable accounting for cash transactions. Industry averages were the reliable means utilized in the audit when no proof and documentation was provided. The department, however, finds that the owner's wages should not have been included in the twenty eight percent cost of salaries and wages. The owner's compensation is a separately stated item on Form 1120S, which could distort the percentage. The industry average does not include officer's compensation, which will be removed from the audit.

FINDING

Taxpayer's protest is sustained.

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